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CURRENCIES AND CREDIT MARKETS

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Among American politicians, this uncomfortable truth (grossly insufficient savings and investments) is being obscured by the strength of the dollar and hopes of a soft landing. Most politicians will put off the hard decisions until a financial crunch forces them to act. Seen in that light, the Louvre Accord to stabilize currencies has hindered rather than helped the curing of America. For the country, the time to cheer will be when America faces not a soft landing but hard truths.

The Economist, London, June 2, 1989, p.15

HIGHLIGHTS

Markets are smitten with a wondrous logic: the bond market boosts the U.S. dollar, the dollar boosts the bond market, therefore both are boosted by higher inflation. With such profitable alchemy even intellectual integrity is sacrificed for the sake of a higher dollar.

Conventional wisdom holds that the dollar is rising because world investors have suddenly discovered that U.S. bonds and equities represent great value. In reality, the favourable trends of all three markets - currencies, bonds and stocks - mutually reinforce each other and have now resulted in a massive exaggeration, both in the sum and in its parts.

Contrary to the latest theory, there is neither a shortage of dollars nor dollar assets in the world. A persistent current account deficit, haemorrhaging $100 billion plus every year, pushes an equal amount of new dollars into world financial markets and investor portfolios.

Theoretically, there should be a tight link between monetary conditions and currency trends. To economists who are familiar with the interplay between money growth and the balance of payments, it is clear that money-growth tends to be a grossly misleading monetary indicator under conditions of large international imbalances.

What feeds the incredible bullish sentiment on the U.S. dollar? If there is any supporting rationale it can be only one thing: the insatiable credit demand of an over-expanded, illiquid colossus of debt accompanied by an unprecedented imbalance between credit growth and available domestic savings.

In our view, a drastic change in perception will soon follow for the U.S. dollar and for that matter all other high-interest rate/high-deficit economies. In the end, these countries will all face the same severe policy dilemma posed by the coincidence of a weakening economy and rising inflation

In our view, there is no chance for a bona fide soft landing. That is because the problem of inflation is much more serious than people want to believe.

TAIL CHASING AND OTHER SUCH SCHEMES

What are the distinguishing differences between the British pound and the U.S. dollar? With the government in deep disarray over economic policy, economists and journalists in London are vying with each other to produce the gloomiest forecast for the U.K. economy. Meanwhile, Wall Street economists and journalists are surpassing each other with rosy forecasts for the U.S. economy all premised on the idea of a "soft landing".

To an observer, both sides have been highly successful in getting their message across. And true to form, once opinions converge, any forecast can become self-fulfilling, at least for a while. That is particularly so of currency movements and their pervasive effects on market sentiment but also because of their relatively direct effects on inflation levels, trade balances and interest rates.

A depreciating currency tends to create a "vicious" circle of accelerating inflation, worsening trade balances and rising interest rates, primarily through its adverse price effects. By contrast, an appreciating currency tends to set in motion a "virtuous" circle of benign interaction between the exchange rate, inflation, trade balances and interest rates which then in turn fuels further demand for the currency and related assets.

THE U.K: AN IMPORTANT CASE STUDY

In the case of the U.K. at least, there are good reasons for the sudden outbreak of doom and gloom over the economy and the pound. One reason is that two crucial fundamentals - inflation and the current-account deficit - are going from bad to worse and from there to worse yet. With an April deficit of L1.66 billion, Britain's current account has been in the red by an equivalent of nearly L20 billion a year over the last six months. That compares with a deficit of L15.6 billion in 1988 and L4.4 billion in 1987. At the same time, a weak pound has increased fears of still-higher domestic inflation - already running at an annual rate of 8.3%.

Another main reason for the pound's vulnerability seems to be the uncertainty over economic policy given evidence of a widening rift between Prime Minister Thatcher and Nigel Lawson, Chancellor of the Exchequer. With the recent softening of the U.K economy, markets now doubt the resolve of authorities to defend the pound with further interest rate hikes should that be so required. Besides, the embarrassing failure to revive the pound with the recent increase in the base rate (by one full percentage point to 14%) suggests that the potency of that weapon has been seriously diminished. As the pound falls, there is growing fear that the final plank in the anti-inflationary strategy will be withdrawn.

In our quest for clues to future exchange rate movements, we are paying particular attention to recent trends in sterling. Readers might remember that not so long ago, the pound was bursting of strength - and not just because of the attractions of high interest rates. For years, there had been expectative talk of a British "supply-side miracle". All of sudden, however, one hardly hears a good word anymore. What has caused this dramatic change in perception?

The Lesson of the Case Study. In our view, this same drastic change in perception will soon follow for the U.S. dollar. For that matter, the same should hold true

for all other high-interest rate/high-deficit economies. In the end, these countries will all face the same severe policy dilemma posed by the coincidence of a weakening economy and rising inflation. As we see it, the inflation results from the preceding boom although its main impact may not be felt until the boom is over. Hence, "stagflation" occurs, a situation in which slow growth or even recession is accompanied by accelerating inflation.

BACK TO CURRENCY MARKET THEORY

In last month's letter, we said that in assessing the U.S. dollar's prospects one should distinguish between three different kinds of influences impacting the currency markets: psychology (or perception), cyclical and monetary conditions, and internal and external fundamentals. We again briefly review some our main conclusions.

Psychology is Still a Major Force. First, market psychology remains strongly bullish for the dollar. Indicative of this mind-set is the ingenuity of economists and investment advisors in finding reasons why the U.S. dollar must rise under all circumstances. In this regard, proven arguments are simply turned on their head, even from one week to the next if so required.

Until quite recently, the forecasts of a strong dollar were based on the notion that a buoyant U.S. economy would raise inflation and interest rates and therefore pull in foreign capital. As soon as the U.S. economy began to weaken, however, the dollar bulls immediately proclaimed that an economic slowdown would be an even better sinecure for the dollar because falling interest rates would trigger a bull market in bonds and stocks with tremendous potential capital gains for investors. They further reason that this strong capital appreciation potential would then pull in more foreign capital.

The wondrous logic, then, is that the bond market boosts the dollar, the dollar boosts the bond market, and that both together are boosted alternatively by rising and falling inflation. With such profitable alchemy, it seems even intellectual integrity has been sacrificed for the sake of higher dollar.

From that perspective, it was quite revealing how financial markets reacted to the shocking announcement that U.S. producers prices had risen 0.9% in May. At first, commentators rushed to explain that without the "volatile" components of food and oil, the underlying inflation rate would "only" be 0.5% (which still annualizes to a 6% per annum). During the first five months of this year, the U.S. producer price index (PPI) has been rising at an annual rate of 9.4%, and is now up 6.2% year-over-year.

Since the PPI figures were much worse than expected, the bond market initially recoiled. But when currency traders started bidding up the dollar, the bond market made an immediate U-turn and jumped almost a point in less than an hour. Bond dealers then rationalized their behaviour by saying that the figures were an aberration, while currency dealers happily concluded that this figure would not allow the Fed to cut interest rates in the foreseeable future - hence maintaining a strong dollar.

Besides interest rate differentials, it is only a delusioned euphoric assessment of the near-and-long-term prospects of the U.S. economy and financial markets that continues to drive the U.S dollar. Even though the economy is now distinctly

weaker than expected, the slowdown is interpreted as a healthy assurance thus raising expectations of the coveted "soft landing". Once again psychology is everything.

The Main Launching Point for the U.S. Dollar Now Fading in the Distance. A second major influence on currency trends, as explained in the last letter, are changes in cyclical and monetary conditions. The dollar has always tended to be strong whenever the U.S. economy has been strong relative to the rest of the world because tight money and high interest rates usually suck in foreign savings faster than the U.S. current-account deteriorates. In reverse, there has been a tendency for the dollar to experience weakness at times of U.S. business downturns because capital outflows accelerate faster than the current account improves as interest rates drop and easier money prevails.

Undoubtedly, the main force bolstering the U.S. dollar onto its original trajectory in recent months was the rise in U.S. short-term interest rates relative to those in Germany and Japan. But now, with U.S. economic growth rapidly slowing, this cyclical and monetary support of the dollar is quickly waning.

The Role of Confidence. Relationships between major currencies have always proved sensitive to changing opinions regarding long-run economic growth differentials determined by internal and external fundamentals. This has been especially so for the U.S. dollar and the Deutsche Mark with ample historical precedent. In the early 1960s, concern over low growth and high unemployment coupled with unattractive interest rates in the U.S., and compared to rapid growth in Europe, led to persistent weakness in the U.S. dollar despite a huge U.S. current-account surplus. In the 1980s, in direct contrast, there has been a perception that Europe and Germany have entered a long period of economic weakness reflected by low interest rates and high unemployment, while the U.S. economy is supposed to have entered a "new era" of sustained fast growth.

We conclude as we've often stressed before: interest rate movements are (and have been recently) the key determinant of exchange rate movements, but the potency of interest rate differentials still rests squarely on confidence and perceptions... meaning confidence both in an economy's health and in the soundness of government policies.

Without such confidence, high interest rates immediately lose their lure. That's what has suddenly happened to the British pound and the Australian dollar. In the final spike in late January 1989, the two currencies were hitting peaks of near DM 3.30 and DM 1.70, respectively. In both cases, the bull-phase evaporated suddenly in February. As the currencies started to slide, the central banks were forced to push up rates for fear that their falling currencies would further fuel inflation. In spite of the newly introduced interest rate increases, both currencies remain under pressure. As confidence waned, the interest-weapon lost its potency.

THE RELATIONSHIP BETWEEN INFLATION PERFORMANCE AND CURRENCIES

During the past two years, currency markets have been governed by interest-rate differentials, irrespective of inflation rates and current-account deficits. Of all high-yielding currencies, why have the two with the highest interest rates

- 14% in Britain and 19% in Australia - suddenly broken ranks with the general trend? The answer is that both currencies were hit by a sudden loss of confidence associated with a perception that these "Latin American" interest rates implicitly mean economic "overkill" and a "hard landing" both for the economies and currencies.

But apart from the issue of confidence, what is actually so bad about these economies as compared to the U.S. and the Canadian economies? Apparently, given their immensely strong currencies, the Canadian and U.S. economies continue to enjoy the favour and the confidence of the financial markets. It's quite an interesting study but it's an exercise more in psychology than in economics.

In Britain, consumer prices are up by more than 8% in 12 months. A major contributing factor, though, has been mortgage-interest payments that were boosted by the sharp rise in short-term interest rates. Excluding this item, inflation would be at about 6%. Following the recent rapid rise, the current-account deficit is now running at an annual rate of 4% of GNP.

In Australia, consumer prices have risen 7% against a year ago. In this case also, sharply rising mortgage-interest payments have been a major contributing factor. But worst of all by international comparison, is the current-account deficit. On the basis of early-year trends, the current account shortfall could reach 5-6% of GNP for the year as a whole.

In Canada, consumer prices are up 5.0% year-over-year. But here mortgage-interest payments are not as large a factor, due to computational differences in the index. Rather, the Canadian CPI has just begun to reflect the inflationary effects of recent revenue hikes by both Federal and provincial governments. As the merchandise trade surplus slumps, the current-account deficit has now widened to 2.5% of GDP.

In the United States, consumer prices are up 5.1% as compared to a year ago. During the first four months of 1989, prices have risen at an average annual rate of 6.6%. By contrast, the current-account deficit shows an improving trend: presently 2.8% of GNP, after 3.5% in 1987.

Now, we come to the rather mysterious part of the story. What about the differences in the inflation performances of these countries? Looking at the facts, the differences do not appear to be as great as currency trends might imply. Rather, most of any contrast seems to apply to the art of presentation and the bias of perception.

Putting it mildly, a good deal of hypocrisy seems to be at play. An inflation rate of 3% in Germany provokes critical comments about the anti-inflationary credibility of the Bundesbank, while an inflation rate of 6% in the United States provokes nothing but complacency and frantic efforts to explain that the "true" inflation is much lower and "moderate" .

For example, in assessing the trend of U.S. inflation, it has become a stock argument that the "volatile" food and oil prices should be left out. Excluding them, the "core inflation" would "only" be 4.5% so the reasoning goes. That may be so, but America isn't the only country on this planet whose consumer price index is impacted by oil and weather-related food prices.

One Must Also Look Past the Price Indexes. Yet, with the help of some fantasy, there may have been a little improvement in the relative inflation performance of the U.S. that might lend support to the dollar. But just as with the relationship between the dollar and U.S. bond markets, there is a fascinating circularity here. While an improved U.S. inflation performance may help to push up the dollar, the dollar's rise has at the same time reduced U.S. inflation and thereby shifted inflationary pressures onto other countries. Indeed, taking these one-time effects into account, a U.S. inflation rate of 5-6% seems even less to crow about.

Of course, such an inflation rate looks "moderate" as long as it's being compared with the high rates of the 1970s or those in Greece and Turkey today. But once observers start judging U.S. inflation in absolute terms, they will find a depressing prospect: annual real GNP growth down to 2%, a current-account deficit of 2.8% of GNP, and an inflation rate still humming at 5-6%. Level-headed market observers would hardly celebrate such a set of conditions as a great achievement.

Moreover, we must recognize that a large current-account deficit is inflation in disguise and reflects excess domestic credit and excess demand. Thanks to the safety valve of foreign trade, excess demand is met by sucking in imports and by diverting potential exports away from foreign markets and into the domestic markets. The larger amount of goods thus made available on the home market moderates the internal rise in prices. In this last analysis, inflation is exported to other countries. Without the benefit of this external outlet for excess domestic demand, the United States - and similarly so, Britain, Canada and Australia - would long ago have been forced to slam on the brakes aborting the consumption boom.

Another widespread argument serving to play down America's inflation problem is that labour cost pressure is moderate, with wages rising "only" 5%. It may seem moderate in comparison with an inflation rate of 5-6%, but the trouble is that it coincides with a downturn in productivity as employment grows faster than output. As a result, unit labour costs are soaring.

According to the Labor Department, unit-labour costs of non-financial corporations rose 6.5% in the first quarter (the largest quarterly gain since 1982). Compared to a year ago, overall unit-labour costs rose 5.8%. Considering the vital relationship between inflation and productivity, U.S. inflation seems likely to be stuck in the 5-6% range even as output growth slows further. As readers know, increased productivity is the only way to absorb higher wages and to improve living standards without driving up prices or squeezing profits.

AN UNRELIABLE LINK BETWEEN CURRENCIES AND MONETARY CONDITIONS

Given the complacency over U.S. inflation prospects, one is tempted to think that a rate of 5-6% is nothing to worry about. Apparently, markets take a great comfort from the perception that the Fed's monetary policy has been extremely tight. In fact, according to the consensus view, the Fed's tight monetary stance is also believed to be the primary force behind the dollar's strength.

No doubt, conventional monetary and financial measures are conveying this impression. The United States has slower money growth than Japan and Germany. One particular chart that is widely used, shows a virtual collapse in U.S. money growth rates. For many commentators, this is proof of a "world dollar shortage"

compared to the overabundant supply of D-mark, Japanese yen and Swiss francs.

To be quite frank, every bit of this story is complete nonsense including the widespread assertion of a reliable link between money growth and currency performance. Theoretically, there should be a tight link. In practice, exactly the opposite has been the general rule over the last two years. As it turned out, the countries with the highest inflation rates, the highest money growth and the highest current-account deficits (Australia, Britain, Canada, Italy, Spain etc.) had the strongest currencies.

What Counts: Money Growth Rates or the Absolute Supply? One thing is sure as the accompanying table shows. The United States has had the lowest money growth in the world, even if only from early 1987. But that followed very rapid money growth in the years before.

INTERNATIONAL MONEY GROWTH COMPARISONS
(% rise on year ago)

	Narrow	Broad
AUSTRALIA	8.8	22.6
CANADA	4.6	11.2
ITALY	7.8	8.4
SPAIN	16.8	11.4
BRITAIN	10.2	20.6
U.S.A.	1.5	4.8
GERMANY	8.9	6.9
JAPAN	8.9	10.3

Before making a judgement on this development, we recommend the reader take a look at the chart on the next page. It provides a little insight into the art of how to lie with statistics. The chart shows two lines running in exactly opposite directions. Yet, they actually reflect one and the same fact: namely, the growth of the wider U.S. money supply (M2). The one line seems to point to a continuous strong monetary expansion while the other warns of a drastic monetary contraction.

How is that explained? Well, the line pointing upwards is based on absolute dollar amounts while the other one relates to changes in money-growth rates.

Of course it is the second - the sharply falling line - that is generally presented as proof of "dollar shortage", domestically and internationally. In our view, this visage of falling money growth gives a grossly distorted picture since it ignores the extremely high money growth in previous years. In the five years from 1984, the broader U.S. money supply has actually expanded more than 40% (or 8% per year in real terms). It was the strongest money growth in the history of the United States, a joyous fact that wasn't lost on buoyant financial markets.

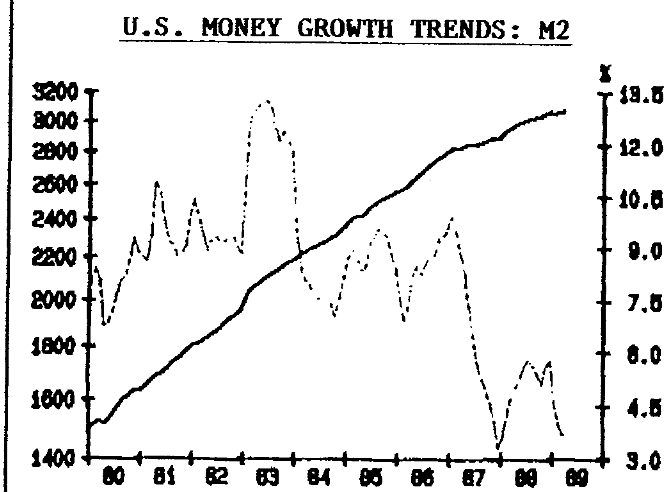
WHEN MONEY SUPPLY IS DIFFERENT FROM LIQUIDITY.

Our main objection, however, is to the conclusion that U.S. money growth rates are well below those of both Germany and Japan. This assertion is grossly misleading because it ignores two crucial factors: first, the effects of the balance of payments on the internal money supply, and second, the underlying high liquidity of the surplus countries.

In the first place, it has to be stressed that any country with a large current-account deficit cannot, by definition, have truly tight money. Such a deficit indicates that domestic spending exceeds domestic output, and such excess spending essentially implies excess credit. The point here is that an external

deficit automatically and equivalently drains the domestic supply of liquidity. Instead, foreign holdings of real and financial assets in the deficit country increase. In short, part of the money creation is pushed out into foreign hands.

To economists who are familiar with this interplay between money growth and the balance of payments, it is clear that money growth tends to be a grossly misleading monetary indicator under conditions of large international imbalances. The larger the external deficit, the smaller should be the increase in the money supply. That's why the International Monetary Fund measures the monetary stance in deficit countries by credit growth - or domestic credit expansion (DCE) - and not by money growth. DCE is simply defined as growth in money supply plus the deficit (or minus the surplus) in the balance of payments.



Solid Line - $ Billion
Dashed Line - % Year-to-Year

As might be guessed, quite a different monetary comparison emerges after one makes an adjustment for differences in external balances. Due to its large external deficit, the United States has far higher debt growth than money growth. While M2 expanded 4% over the last 12 months, debt swelled by 9%. German debt growth, by contrast, has been around 6%. Paradoxically, Canada, the country which has had the strongest currency recently, has both far higher debt and money growth than Germany and the United States. Canadian credit growth is still running at 12%.

No Shortage of U.S. Dollars. In conclusion, both money growth and even credit growth are not reliable indicators of currency performance. There is neither a shortage of dollars nor dollar assets in the world. A persistent current account deficit, haemorrhaging $100 billion plus every year, pushes an equal amount of new dollars into world financial markets and investor portfolios. Since 1984, the cumulative current account deficit now amounts to almost $700 billion. That's almost as much as the increase in the U.S. money supply (M2) of about $900 billion over that same time period.

THE SOURCE OF LIQUIDITY ALSO MAKES A DIFFERENCE

Our second profound objection to the consensus view that sees tight money in the United States and easy money elsewhere, concerns the character and underlying source of liquidity differences. No doubt, Germany is incomparably more liquid than the United States. But, it would be a gross error to attribute this feature to monetary policies alone. It's a far deeper question than that.

In reality, the main difference in the composition of liquidity between the two countries is found in the domestic availability of savings. The German economy

is flush with savings from current earnings while the U.S. economy is floating with a surfeit of debt and borrowed money.

The difference in savings patterns is stark. The U.S. national savings rate, defined as private household and corporate savings minus the budget deficit, has dropped markedly during the 1980s from about 6.5% to 2.5% of GNP. During the same time, the German national savings rate calculated in the same way, increased sharply from 9% to 16.5% of GNP.

Americans like to attribute the huge capital flows into the United States to superior investment opportunities and attractive rates of return. The relevant point that is made is that capital flows from "undynamic high-saving countries" to a "highly dynamic low-saving country" like the United States or any other, make perfect economic sense, and therefore should be sustainable over the longer run. High interest rates must simply reflect higher rates of return in the U.S. economy. This viewpoint, too, is certainly part of the markets' positive perception of the U.S. economy and the dollar.

In the view of many American economists, low savings mean high spending, and this, in turn, implies high investment. Unfortunately, the truth is just the opposite. As a share of GNP, U.S. net investments have fallen to an absolute low of barely 5%. That is little more than half the German net investment rate of 9.5% of GNP presently.

There is quite an irony in this development. In the United States, net investment has fallen, but available savings fell even faster. In Germany, net investments have risen, but available savings rose much faster.

What, then, feeds the incredible bullish sentiment on the U.S. dollar? If there is any supporting rationale it can be only one thing: the insatiable credit demand of an over-expanded, illiquid colossus of debt accompanied by an unprecedented imbalance between credit growth and available domestic savings. And to make thing worse, U.S. credit demand is mainly driven by consumption and asset speculation. In other words, the sheer strength of the U.S. credit demand relative to the rest of the world may help to pull in foreign money. The graph on the next page, which shows a veritable debt explosion, leaves little doubt that there must be some truth to that assertion.

The only other driving factor to the U.S. dollar is a massively inflated optimism over the prospect of a "soft landing", moderating inflation, sharply falling interest rates and the "best bond and equity bull markets of a lifetime in prospect".

UNDERPINNINGS TO THE DOLLAR TODAY VERSUS 1984.

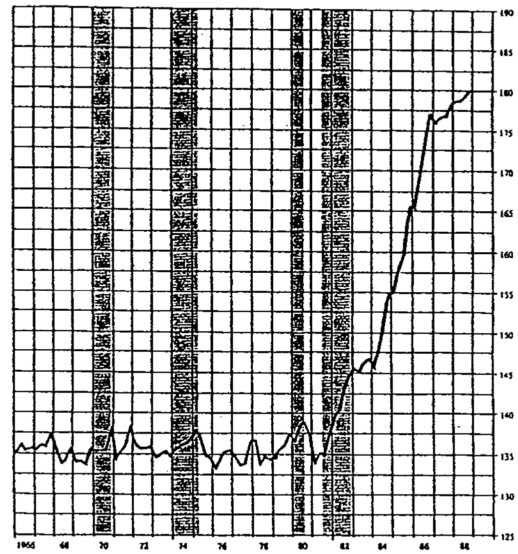
As we explained in the last letter, falling long-term interest rates may increase a currency's attractiveness to foreign investors through the hope of capital gains, but only for a while. This can happen even though interest rate differentials become reduced and less attractive. That is what happened in 1984/85, but as we added, under conditions that were totally different from today.

One might remember that in 1984, U.S. bonds prices began their uptrend starting from rates at the 13.5% level. A helpful development was the fact that the

inflation rate fell from 4.8% to 3.5% during the year. This time, long-term bond yields are between 8-9% and inflation is between 5-6% and is still rising. Seen in this light, the present euphoria in U.S bond markets is simply grotesque.

And what about the bullishness in the U.S. stock market? The profit boom that is claimed to be its driving force is just another hoax. Since 1986, U.S. corporate profits have been grossly inflated by soaring inventory profits due to a sharp rise in commodity prices. Excluding these illusory gains, after-tax profits are considerably lower than they were in 1984 when the Dow Jones index hovered around the 1200 level. And another irony is that the best part of U.S. corporate profits has been contributed by European affiliates in recent years. Foreign profits of U.S corporations, excluding currency translation, rose 32% in 1987 and by more than 40% in 1988.

UNITED STATES: TOTAL NON-FINANCIAL DEBT AS A % OF GNP



Quarterly data. GNP is seasonally adjusted. Recession periods are shaded. Thru Dec.88.

Meanwhile, weak economic growth together with rising labour and interest costs along with soaring indebtedness are likely to take an increasing toll of U.S. corporate earnings and cash flows.

Conventional wisdom holds that the dollar is rising because world investors have suddenly discovered that U.S. bonds and equities represent great value. However, that causal chain also works equally in reverse. In reality, the favourable trends of all three markets - currencies, bonds and stocks - mutually reinforce each other and have now resulted in a massive exaggeration, both in sum and in parts.

The key sparkplug, though, seems to be the dollar, But what is the key to the dollar? In one word: perception. The dollar's critical and basic prop, as explained in the last letter, is a widespread perception that everything is fine in the U.S economy. It is simply wishful thinking over the prospects of a "soft landing".

STRUCTURAL ISSUES IMPACTING INFLATION AND CURRENCIES

In our view, there is no chance for a bona fide soft landing. That is because the problem of inflation is much more serious than people want to believe. Surely, there is no real danger of runaway inflation, but an inflation rate of 6% may remain endemic due to record-low savings, record-low investment and absent productivity gains. In the United States, as in some other countries, inflation is not just a figment of monetary policy but also a symptom of some deep structural problems.

The low investment ratio of the United States leaves little hope that the U.S. trade balance may improve in the long run. After all, the U.S. trade gap reflects

the same underlying cause as the endemic inflation rate: low investment. That conclusion is crystal clear viewing the table below which highlights the negative developments for both the U.S. and England in this connection.

Reviewing the table, one is tempted to say that both the United States and Britain are growing out of the international division of labour. The manufacturing sectors of these countries are being savagely squeezed by skyrocketing import penetration and falling market shares in world trade.

MARKET SHARES FOR MANUFACTURING

COUNTRIES	1960	1973	1980	1985	1987	1960	1973	1980	1985	1987
	Imports of manufactured goods as a percentage of manufacturing value added at current prices					Exports of manufactured goods as a percentage of world exports of manufactured goods at current prices.				
United States	4.6	13.8	21.5	31.0	35.1	22.3	14.8	15.6	15.2	12.7
Japan	7.5	8.0	10.4	10.2	9.6	6.2	11.5	13.5	17.9	16.3
Germany	24.6	25.1	39.0	47.1	43.0	17.4	19.9	18.1	16.9	19.5
United Kingdom	16.3	39.1	51.1	69.5	72.2	15.0	8.5	8.8	7.1	7.2

Source: 58th Annual Report, Bank of International Settlements. June 1988, p.29.

The statistics in the table leave little doubt that the U.S. trade problem - just as that of Britain - reflects a long-term trend that has been in progress ever since the end of the war regardless of business cycles and repeated devaluations. At the root of this trend is the fact that the United States and Britain have the lowest national savings and net investment ratios of all of industrial countries. Capital formation is the key. It takes substantially more than just favourable exchange rates to compete internationally. One must also have the capacity to deliver the goods to increase or maintain market share. Given record-low savings and investment, their manufacturing sectors are being "crowded out" by foreign competitors. Worst of all, this trend continues to deteriorate with no improvement in sight.

SUMMARY CONCLUSIONS

There is much talk of the highly positive fundamentals behind the dollar's surge. This rather reminds us of the fairy-tale about the naked emperor whom everyone beheld to be attired in beautiful clothes. Just what are these positive fundamentals? An inflation rate of 5-6%, zero productivity growth, labour unite costs rising at 6%, real economic growth at approximately 2%, falling real business profits, are all trends generally worse than expected and hardly qualify as positive. Although still huge, the only silver-lining is a narrowing current account deficit.

At present price levels, how can U.S stocks and bonds be considered bargains under these dismal conditions. As a matter of fact and example, real U.S long-term interest rates are now lower than in Germany or France. Where's the value?

Taking into account the tremendous differences in savings and investment ratios, we can only say that, in every respect, U.S. economic fundamentals make extremely poor comparisons when compared to such countries as Germany and others. German real GNP is up 4.2% over a year ago. With the help of good weather, first quarter

economic growth was even running at a clip of 12% (seasonally adjusted and annualized). Add to that excellent business profits that are still soaring, lower inflation of 3.1%, a contained budget deficit of 1% of GNP, an investment boom, and, on top of all that, a record-high and still rising current-account surplus equivalent to 4% of GNP the comparison seems rather one-sided.

Actually, we are at a complete loss in understanding the present euphoria about the U.S. economy and the prospects for its financial markets. Apparently, many people have bought the idea that a slowing economy will simply do wonders for inflation, interest rates and, therefore, financial markets.

Everything hinges on the strong dollar. Dollar strength is regarded as the rosy symbol of economic health and from that follows the associated belief that strength in the dollar is bullish for U.S. bonds and stocks. That sounds agreeable enough, but it does throw everything back to the question of how solid are the underpinnings to recent dollar strength.

We can only repeat what we have said before. For the time-being, currency has become a measure of sentiment. And sentiment on the U.S. economy and U.S. economic policy is highly positive. That's all that's to it. Strong sentiment combined with widespread chart-oriented trading quickly produces a self-reinforcing trend.

Once a few resistance points are broken on the chart, massive short-covering and bullish buying ensues until, of course, something happens to again bring sentiment back closer to reality (perhaps in the same fashion as happened to the pound and the Australian dollar). More directly said, U.S. dollar strength is a bubble that may burst at any time. One shouldn't forget that chartists reserve the right to change their minds on an instants notice.

We see one important factor that may keep a U.S. recession and a sudden steep decline in the dollar at bay for a while longer. That's the booming world economy and the enormous cyclical differential that has developed between the United States and the rest of the world. Now it's Europe and the Far Eastern countries that are sucking in imports at double-digit rates on the back of surging domestic demand while U.S domestic demand growth has slowed to a trickle.

All this may foster illusions about the underlying strength of the U.S. economy. as the strong dollar simultaneously softens the inflation trend and even helps to narrow the trade deficit over the short run as it decelerates import prices (the "J" curve effect). For appearance sake, the strong U.S. dollar is of tremendous benefit for the time being. But the reality is that problems are simply stored and swept away into the future.

In theory, therefore, the U.S. economy and the dollar may hold up until year-end or early 1990, given the extent of the one-sided speculation and realizing that most financial institutions trade currencies based on simple trend and momentum models. Yet, experience says that it is precisely at times like these, when markets become so extremely one-sided, that it is worth focusing on the fundamental factors which are already acting against the universally accepted trend.